United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

ORIGINAL

74-2434

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 74-2434

HICKS NURSERIES, INC.

Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

ON APPEAL FROM
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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PRELIMINARY STATEMENT

The Commissioner appeals from so much of the decision of the United States Tax Court (by the Honorable Charles R. Simpson), dated May 6, 1974 and reported at 62 T.C. 138, as determined that the Taxpayer, Hicks Nurseries, Inc., had only ten shareholders within the meaning of section 1371 of the Internal Revenue Code of 1954 (hereinafter the "Code")[1] and

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[1] All references herein to sections are to sections of the Code.

§ 1.1371-1(d)(2) of the Income Tax Regulations when it elected to be taxed pursuant to the provisions of Subchapter S of the Code as a "small business corporation" (commonly, and hereinafter, referred to as a "Subchapter S corporation").[2]

The Taxpayer concurs in the factual statement of the case as presented in the brief for the Commissioner. The fully stipulated facts (Appendix pp. 4-6) are not in dispute and need not be repeated here at length. At the time the Taxpayer filed its Subchapter S election, all of its stock was owned by eight individuals and two married couples. Each of the married couples owned some stock in the Taxpayer jointly and all four of these husbands and wives owned other stock in their individual names. This arrangement of stockholdings was fully disclosed in the election to be taxed pursuant to Subchapter S filed by the Taxpayer for the year 1964. Appendix p. 10. The Commissioner determined that the election was invalid because at the time it was filed the Taxpayer had more than 10 stockholders and asserted income tax deficiencies for the years 1964 through 1967 in the amount of $253,334.29, plus interest. The Tax Court determined that the election was valid since the Tax-

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[2] The Commissioner does not appeal from that part of the decision of the Tax Court holding that the Taxpayer's Subchapter S election did not terminate in 1966 upon the failure of a deceased shareholder's executrix to file a consent to the election because a valid consent was subsequently filed pursuant to an extension of time validly granted, and invalidly revoked, by the District Director.

payer had only 10 shareholders within the meaning of subsections 1371(a) and (c) and that there was no deficiency in income tax for the years in question.

ARGUMENT

Subchapter S corporations are, in general, relieved of the normal corporate income tax but the entire income or loss of such corporations is directly taxed to its shareholders in a manner similar to the taxation of partnerships. Pursuant to section 1371(a)(1) only corporations having 10 or fewer shareholders are eligible to elect Subchapter S status but section 1371(c) sets forth a special rule for computing the number of shareholders for the purposes of section 1371(a)(1). Section 1371(c) provides in substance that stock which is held by a husband and wife as joint tenants shall be treated as held by one shareholder. This subsection does not specify how stock individually owned by married joint tenants is to be counted but it is not disputed that individual holdings are not to be counted as creating stockholders in addition to the "one stockholder" of the jointly owned stock. The required synthesis of sections 1371(a) and (c) is set forth in § 1.1371-1(d)(2)(i) of the Regulations which states that "if a husband or wife owns stock in the corporation individually, and the husband and wife own other stock in the corporation

jointly, the husband and wife will be considered one shareholder." The Tax Court held that the word "or" in this Regulation carries its usual meaning of "and/or," that it includes the conjunctive and that the one shareholder rule is applicable regardless of whether one or both of the husband and wife own stock individually. The Commissioner argues that the word "or" in question is solely disjunctive and that the words "but not both" should be read into the Regulation. But neither the context of the Regulation nor the policy of section 1371(c) requires that an abnormal meaning be given this "or". In fact, the Congressional policy of expanding the permissible number of married shareholders of a Subchapter S corporation and the context and literal meaning of the Regulation support the Tax Court's construction. Further, the position of the Commissioner that the Taxpayer had 12 shareholders requires that the jointly held stock be treated as owned in part by the husband and in part by the wife, that is, by two shareholders--in direct conflict with section 1371(c).

In the event that this Court concludes that the Regulation does not clearly require that the decision of the Tax Court be affirmed, the Taxpayer argues in the alternative that the ambiguity in the Regulation should be resolved in favor of the Taxpayer.

Point I: The Code itself does not provide a rule for computing shareholders where one or both spouse own stock individually as well as jointly.

Subchapter S of the Code, added by the Technical Amendments Act of 1958 and presently including sections 1371 to 1379, was enacted by Congress along with numerous other tax and nontax provisions for the purpose of providing assistance to small, family owned businesses such as that conducted by the Taxpayer. See, The A. & N. Furniture & Appliance Co. v. United States, 271 F. Supp. 40 (S.D. Ohio 1967). The requirements that a corporation must meet before it is entitled to elect Subchapter S status are set forth in section 1371 and include the limitation in subsection (a) that the corporation may not "have more than 10 shareholders." Section 1371 (a)(1).

As originally enacted, section 1371 did not contain the present subsection (c) which provides a special rule for computing the number of shareholders when stock in the corporation is owned by a husband and wife. Thus, § 1.1371-1(d) of the proposed Regulations issued under the original section 1371 on March 12, 1959, took the position that for the purpose of the 10 shareholder computation, where stock is owned as community property or by a concurrent tenancy, each person having a communal or concurrent interest in such stock would be considered a shareholder. The effect of this construction of

section 1371 was to reduce the permissible number of shareholders of a Subchapter S corporation to five married couples, a result not contemplated by Congress. Accordingly, in the same year section 1371 was amended by adding subsection (c) to provide a special exception to the rules for computing the number of shareholders where both a husband and wife owned stock. This new subsection provided as follows:

> "(c) STOCK OWNED BY HUSBAND AND WIFE.--For purposes of subsection (a)(1) stock which--
>
> (1) is community property of a husband and wife (or the income from which is community income) under the applicable community property law of a State, or
>
> (2) is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,
>
> shall be treated as owned by one shareholder."

While this amendment to the Code clearly overruled the position adopted in the proposed Regulations with respect to stock communally or concurrently owned by a husband and wife, subsection (c) refers only to the jointly held stock itself and thus does not address the sole issue presented by this appeal: the treatment of stock held in the individual name of the joint tenant.

At times, the Commissioner appears to argue on this appeal that the relationship between subsections (a) and (c) is clear from the face of the statute, that the 10 shareholder limitation of subsection (a) is applied first and if

both the husband and wife individually own stock, two shareholders are to be counted and no reference is to be made to subsection (c). But subsection (c) cannot be so easily ignored. It is not disputed that the one shareholder rule of that subsection was intended to override the general rule of section 1371(a) when the stockholders include married couples owning some or all of their stock concurrently or as community property. Subsection (c), therefore, whenever it is applicable must necessarily take precedence over subsection (a). Thus, whenever a husband and wife jointly own stock in a Subchapter S corporation, reference must be made to the overriding rule of subsection (c) to determine its impact on the general rule.

Assuming that reference is to be made to subsection (c), the next question is whether both subsections (a) and (c) can be applied independently and according to their terms without resort to synthesizing rules not found in the statute. On this point, there appears to be no dispute. The Commissioner on this appeal correctly observes that "the statutory provisions do not explain how the 'one shareholder' rule for jointly held stock should be applied when the parties . . . also hold stock in their own separate names" (Appellant's Brief, p. 16) and that the Treasury Department was required to synthesize the new subsection (c) with the general rule of subsection (a) by regulations. The reason that such a synthesis

was required and that subsections (a) and (c) cannot be applied independently is that subsection (c) does not identify the "one shareholder" of the jointly owned stock. If the "one shareholder" of the jointly held stock were independent from the owners of stock held in individual names, and one spouse held stock in his or her individual name, there would still be two shareholders (of the jointly held stock and of the individually held stock). Where both held stock individually, there would now be three shareholders (the husband, the wife, and the joint owners) where there were only two prior to the addition of subsection (c). Under this construction, the relief extended by subsection (c) would be very limited indeed for it is rarely the case that married couples own all of their stock jointly or as community property. Further, where both the husband and wife owned stock individually, such a construction of subsection (c) would increase the computation of shareholders--precisely the opposite result from that clearly intended by Congress. Indeed, although the legislative history of subsection (c) is not as illuminating as one would like, the only Committee Report that addresses itself to this subject indicates that Congress believed it was enacting a provision under which all husbands and wives who owned stock in a Subchapter S corporation jointly would be treated as one shareholder:

"Subsection (a) of section 2 [adding subsection (c)] makes it clear that, in determining the number of shareholders of a small business corporation, a husband and wife owning stock jointly or as community property shall be counted as only one shareholder." S. Rpt. No. 913, 86th Cong., 1st Sess.

Point II: A proper synthesis of subsections 1371(a) and (c) is contained in the Regulations and such Regulations are dispositive of this appeal.

The final Regulations to section 1371 were similar to those previously proposed except that in § 1.1371-1(d), entitled "Number of shareholders," after the statement of the general rule prescribing the 10 shareholder limitation appears a second paragraph entitled "Stock owned by husband and wife," the first four (and only relevant) sentences of which read as follows:

"(2) STOCK OWNED BY HUSBAND AND WIFE. (i)[1] Except as otherwise provided in this paragraph, in determining whether a corporation meets the 10-or-fewer-shareholders requirement of section 1371(a), stock which--

(a) is community property of a husband and wife (or the income from which is community income) under the applicable community-property law of a State, or

(b) is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,

shall be treated as owned by one shareholder. [2] For this purpose, if a husband or wife owns stock in a corporation individually, and the husband and wife own other stock in the corporation jointly, the husband and wife will be considered one shareholder. [3] However, if the husband and wife each owns stock in the corporation individually, they will be treated as two

> shareholders. [4] This subdivision applies only in determining the number of shareholders for purposes of section 1371(a)(1) and does not apply for purposes of any other provisions of subchapter S, chapter 1 of the Code." (Numbers added)

As may be seen, the Treasury Department recognized that subsections (a) and (c) could not be applied independently and that, in order to effectuate the Congressional objective in adopting subsection (c), a synthesis of these provisions was required. That synthesis is contained in the second sentence of the Regulation and is based upon the recognition that Congress intended the subsection (c) exception to override the general rule of subsection (a) whenever the two provisions conflicted. Thus, this second sentence provides that in any case where subsection (c) is applicable, because stock in the corporation is held by a husband and wife jointly or as community property, the "one shareholder" rule of subsection (c) prevails and the individual ownership of stock is to be disregarded. As will be demonstrated, this construction of subsection (c) is the only construction that is consistent with the statutory language.

The Commissioner concedes that under the synthesis established by the Regulation, the individual ownership of stock by one spouse is to be disregarded but denies that the individual holdings of the other spouse are also to be disregarded. The Commissioner's entire argument is based on the

contention that, contrary to normal English usage and established rules of statutory construction, the word "or" in the second sentence of the above quoted Regulation is solely disjunctive and does not include the conjunctive; that this particular "or" means "A or B but not both" rather than "and/or." The extent to which this construction of the word "or" is contrary to normal English usage is evidenced by the Commissioner's brief wherein he was compelled to insert repeatedly the parenthetical "but not both" in attempting to explain his reading of the Regulation in question.

Further, the Income Tax Regulations expressly adopt the generally accepted rule of statutory construction in the following language:

> "As used in section 368, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction 'or' denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if 'stock and securities' are received in exchange as well as if 'stock or securities' are received." Regs. § 1.368-2(h).

Not only is the word "or" used hundreds of times in a variety of contexts throughout the Code and Regulations to mean "one or the other or both" but the word is so used in the very paragraph in question. Subparagraphs (a) and (b) of the Regulation are joined by the word "or" and the stock described in subparagraph (a) is stock which is community property "or" the income from

which is community income. Indisputably, these words "or" in the first sentence of the Regulation include the conjunctive "and/or." If the same word in the next sentence of the Regulation is to be given a different, and abnormal meaning, that result must be clear from the overall context in which the word appears or from a defined principle of substantive tax policy. The language of a Regulation cannot properly be given a special, hidden meaning in order to arrive at a purely arbitrary construction of the Code for then the Regulation becomes a mere trap--for the wary as well as the unwary--and would subvert rather than administer the intent of Congress.[3]

The Commissioner argues that the overall context of the Regulation and particularly the third sentence thereof require adopting an unusual meaning of the word "or" in question. There is no dispute as to the meaning of the first sentence of the Regulation which merely sets forth the one shareholder rule where all stock is communally or concurrently owned. The introductory clause "except as otherwise provided

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[3] Cf. Greyhound Corporation v. United States, 495 F.2d 863, 869 (9th Cir. 1974) ("In construing a revenue act, we presume that the legislative authority uses words in their ordinary sense and with the meanings commonly attributable to them. Commissioner v. Plestcheeff, 100 F.2d 62 (C.A.9 1938). Where the statute does not define the words used, they must be accepted in their ordinary everyday meaning.")

in this paragraph" does not limit the one shareholder rule but relates to the fourth sentence of the Regulation which provides that the husband and wife are treated as two shareholders for other purposes of Subchapter S such as the requirement that each shareholder execute a consent to the Subchapter S election.

The second sentence contemplates individual as well as joint ownership and provides that the husband and wife continue to be treated as one shareholder.

The third sentence, in the view of the Taxpayer and the Tax Court, that "however, if the husband and wife each owns stock in the corporation individually, they will be treated as two shareholders" covers the final possible combination of husband and wife shareholdings: no stock held jointly and stock held individually by both the husband and wife. The Commissioner concedes that such is the literal meaning of the third sentence but again argues that the intended meaning of this sentence is something different because, he suggests, such meaning would render the third sentence "extraneous," "irrelevant" and "not pertinent" to the paragraph in question which, he suggests, is solely addressed to stockholding combinations by husbands and wives that include jointly held stock. But the Commissioner finds no support at all for his contention that the entire paragraph contemplates joint ownership. Aside from his repeated ex cathedra assertion that a different view would be contrary to law and his rather odd reliance on the caption to the paragraph, "Stock owned by husband and

wife," which does not even refer to joint ownership, the Commissioner's argument is totally circular. Initially he argues that the entire paragraph contemplates joint ownership because the third sentence covers the situation of both a husband and wife owning stock individually and other stock jointly--precisely the matter in dispute. Appellant's Brief, p. 18. Thereafter, he argues that the second sentence is not applicable to the facts presented by this appeal because the third sentence controls and that the third sentence controls because the entire paragraph contemplates joint ownership. Appellant's Brief, p. 22. Thus, the Commissioner's argument comes full circle and does not advance his position in the least. In plain fact, the Regulation when read as a whole is entirely consistent with the construction thereof by the Tax Court. Judge Simpson's reading of the third sentence as a helpful caution to taxpayers that a husband and wife that do not fit within the rule set out in the previous two sentences will be regarded as two shareholders is entirely reasonable.

Point III: The Congressional policy underlying subsection (c) requires that the decision of the Tax Court be affirmed.

The Commissioner's argument not only finds no support in the context of the Regulation; it is flatly contradicted by any argument based in logic, symmetry or tax policy. Indeed, we do not understand the Commissioner to assert that his

construction of the Regulation is more rational than that adopted by Judge Simpson in the Tax Court or that it better executes a principle of tax policy. Rather, he is content to argue that the Regulation in fact sets forth the rule for which he is arguing. However, the literal, normal meaning of the Regulation is to the contrary and supports the decision of the Tax Court and the context of the disputed language is at least as consistent with such meaning as with the interpretation proposed by the Commissioner. Accordingly, unless there is some basis in logic or policy for the position of the Commissioner that was not perceived by Judge Simpson, the opinion below must be affirmed.

But the Commissioner's argument finds no support at all in tax policy or common sense. The purpose of the 10 shareholder requirement is to limit the availability of Subchapter S to corporations having a small number of shareholders. It is not disputed that pursuant to subsection (c), if a husband and wife have a joint interest in the corporation, under at least some circumstances, they will be counted as only a single shareholder for the purpose of this size limitation. Furthermore, the Commissioner concedes that subsection (c) applies to produce only one shareholder even though the husband and wife have an unequal interest in the corporation because one spouse holds stock in his or her individual name. Indeed, there is no doubt but that had the husbands and wives in this case transferred all their shares into tenancies in common

without rights of survivorship, thereby preserving their disparate stockholdings in the form of undivided interests, the 10 shareholder requirement would have been met. There is no substantive basis for distinguishing these permissible arrangements from the case at hand: permitting both the husband and wife to own stock individually does not increase the total number of individuals having an interest in the corporation or the number of such individuals having divergent interests in the corporation. Accordingly, the construction adopted by the Tax Court does not expand the relief intended by Congress in adopting subsection (c). Rather, the interpretation proposed by the Commissioner would unduly restrict the relief intended by curtailing a desirable flexibility in the arrangement of stockholdings in small, typically family owned, businesses without achieving any substantive objective of tax policy or administration.

In this respect, the case presented by this appeal is not unlike the case considered by the Court in The A. & N. Furniture & Appliance Co. v. United States, supra, in which shareholders of a Subchapter S corporation had placed their stock in a voting trust. In addition to the 10 shareholder limitation considered herein, section 1371(a) also requires that a Subchapter S corporation have only one class of stock and have only individuals and estates as shareholders. The Commissioner argued that having some stock of the corporation

in a voting trust created a second class of stock and that, alternatively, the voting trust was a shareholder other than an individual. The Court reviewed the legislative history to Subchapter S and determined that the definitional requirements of section 1371(a) were designed to limit the tax relief to corporations that, because of their small number of shareholders, were comparable to partnerships and to minimize the accounting complications that would be imposed upon the Government in auditing such corporations and their shareholders. The Court concluded that, in contrast to a normal trust which could have many beneficiaries, a voting trust could not increase the number of beneficial owners of the corporate stock and would not complicate tax accounting. The Court, in construing section 1371(a) to permit the voting trust, concluded that:

> "If the voting trust affects neither of these legitimate concerns of the Internal Revenue Service, then we can see no reason for the formulation of a series of strict technical rules affecting the internal operations of small businesses." 271 F.Supp. at 45.

This Court should similarly conclude that the restrictive construction of the 10 shareholder limitation here proposed by the Commissioner has no basis in the Congressional policy underlying section 1371. In the A. & N. Furniture case, in order to arrive at its conclusion, the Court was required to hold invalid that portion of § 1.1371-1(e) of the Regulations which specifically prohibited voting trusts from holding stock

in a Subchapter S corporation. In this case, the Regulation in question as construed by the Tax Court is entirely consistent with the policy of Subchapter S and that interpretation should be affirmed by this Court.

Point IV: The rule proposed by the Commissioner is inconsistent with the statute.

While the Commissioner asserts that the decision of the Tax Court "was incorrect as a matter of law" (Appellant's Brief, p. 11) and suggests that Judge Simpson failed to consider whether his opinion was "in conflict with the statute" (Appellant's Brief, p. 15)--while conceding that the statute does not address the facts presented by this appeal (Appellant's Brief, p. 16), in fact the construction of the Regulation adopted by the Tax Court is the only synthesis of subsections 1371(a) and (c) that is entirely consistent with subsection (c), the more recently enacted provision. By contrast, the construction favored by the Commissioner requires that, on the facts presented by this appeal, subsection (c) be disregarded in a manner that would cast doubt on the validity of the Regulation. Subsection (c) provides without exception that stock jointly owned by a husband and wife be treated as owned by one stockholder. But this provision does not require counting a husband and wife who each own stock individually and other stock jointly as three stockholders--and neither the Regulations nor the Commissioner have ever suggested that it

did.[4] Rather, the Commissioner argues that this pattern of stockholdings produces two stockholders which can only be the case if the jointly owned stock is regarded as held as undivided interests by two shareholders (there being no basis for imputing the stock to one or the other individual) in direct conflict with the literal requirement of subsection (c).

Thus, again the Commissioner's argument requires disregarding the literal language of a provision in order to achieve the result he seeks. Here he is arguing that subsection (c) is applicable according to its terms where, in addition to the jointly held stock, only one spouse owns stock in his or her individual name but that there is an implied exception to the rule of subsection (c) where both a husband and wife own stock in their individual names. There is no authority whatsoever for an exception to the clear language of subsection (c) or for drawing a distinction between the individual ownership of stock by one spouse and the individual ownership of stock by both a husband and wife. Nor is there any reason for this Court to create such an exception.

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[4] At times the Commissioner's brief states that the Taxpayer had "at least 12" stockholders as if to reserve the argument that such a pattern of stockholdings did create three stockholders. But that construction of section 1371 is not only in direct conflict with the construction of the Regulation that the Commissioner is here urging but also would require the Commissioner to argue that the Regulation is invalid.

Contrary to the Commissioner's argumentative assertion that Judge Simpson did not consider whether his construction of the Regulation was "consistent with or authorized by the statute" (Appellant's Brief, p. 5), it is entirely clear that Judge Simpson fully considered the provisions of section 1371. It is equally certain that he regarded the Regulation as a proper exercise of the Treasury Department's statutory authority to "supply the details"[5] omitted from the statutory language and undertook to construe that Regulation in a manner that avoided raising any question as to the validity of the Regulation under the statute. As that construction is also more in harmony with the Congressional intention of expanding the permissible number of stockholders of a Subchapter S corporation when married couples are stockholders than is the construction urged by the Commissioner, the Tax Court's construction should be affirmed by this Court.

Point V: Alternatively, even if the Regulations do not clearly require that the decision of the Tax Court be affirmed, the Taxpayer should be given the benefit of the ambiguity.

The Taxpayer submits that the construction of the

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[5] Guiseppe v. Walling, 144 F.2d 608, 622 (1944). Because the Treasury Department has so fulfilled its task, it was not necessary for the Tax Court below, and is not necessary for this Court, to engage in its frequent task of "filling in the gaps" in the statutory pattern. Guiseppe v. Walling, 144 F.2d at 622.

Regulation adopted by the Tax Court is correct and the construction suggested by the Commissioner is erroneous. But even if the Regulations are not thought clearly to require a decision in favor of the Taxpayer, the Regulations are at least highly misleading and ambiguous. In construing the Income Tax Act of 1913, the Supreme Court early established the principle that "in case of doubt they ["statutes levying taxes"] are construed most strongly against the Government, and in favor of the citizen." Gould v. Gould, 245 U.S. 151, 153 (1917). This rule of statutory construction has been reaffirmed repeatedly by the Supreme Court[6] where there has been an absence of a settled administrative practice and is as valid today as when first announced.[7]

The application of this rule is particularly appropriate in this case where there is no prior administrative prac-

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[6] Hassett v. Welch, 303 U.S. 303, 314 (1938); White v. Aronson, 302 U.S. 16 (1937); Reinecke v. Northern Trust Co., 278 U.S. 327 (1929); Shwab v. Doyle, 258 U.S. 529 (1922).

[7] Greyhound Corporation v. United States, 495 F.2d 863 (9th Cir. 1974); B & M Co. v. United States, 452 F.2d 986, 990 (5th Cir. 1971); Commissioner v. Pan-American Life Ins. Co., 111 F.2d 366, 368 (5th Cir. 1940) ("the most that can be said in favor of the construction urged upon us by the commissioner, in the light of the administrative interpretation, is that the statute is sufficiently ambiguous to give rise to a reasonable doubt as to its meaning, which we are required to resolve in favor of the taxpayer.")

tice at all, the ambiguity could have been eliminated by the addition of a very few words, and the construction urged by the Taxpayer does not entail any adverse impact on the federal revenues.

Furthermore, Subchapter S was enacted by Congress as a relief provision designed to free small businessmen from the prohibitive tax consequences of incorporation.[8] Similarly, subsection (c) unquestionably is a remedial provision intended by Congress to provide relief to husbands and wives owning stock in Subchapter S corporations--a relief provision with a relief provision. As this Court stated in reviewing other, similarly ambiguous taxing statutes:

> "The statute may be characterized as a remedial one intended for the relief of certain classes of taxpayers. It is axiomatic that such a statute should be construed in favor of those intended to be benefited".[9]

Certainly, in the situation presented by this appeal it is more appropriate to rebuff the Commissioner, who may easily enforce his construction of the Code through the promulgation of unambiguous Regulations, than to penalize the Taxpayer

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[8] The A. & N. Furniture & Appliance Co. v. United States, supra; W. C. Gamman, 46 T.C. 1 (1966.).

[9] Hollander v. United States, 248 F.2d 247, 251 (2nd Cir 1957).

and its shareholders (whose individual cases are being held in abeyance pending the outcome of this case) who relied in good faith on the Regulations as they and their advisors understood them. As pointed out by Judge Simpson, the Taxpayer and its stockholders took affirmative action on the basis of a reasonable construction of the best evidence available to them of the statutory requirements. Had the Regulations clearly set forth a different rule, different action could then have been taken to secure the tax advantage that Congress made available to them. To permit the Commissioner subsequently to adopt and enforce a different construction would create an irreparable harm to the Taxpayer of the same nature as the retroactive amendment of the statute itself. While such a consequence cannot always be avoided where the construction adopted by the Taxpayer can be shown to be in conflict with law, tax policy or the sound administration of the income tax laws, such a case is not presented by this appeal which involves a purely arbitrary construction of a definitional provision.[10] In simple fact, the construction made by the Taxpayer and adopted by the Tax Court is at least as reasonable in substance as that now adopted by the Commissioner and possesses the distinct advantage of corresponding more closely to the literal language of both the Code and Regulations.

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[10] Nor does this case involve any related or unrelated principle of income, gift or estate tax policy. There has never been any suggestion that the husbands and wives involved herein were engaging in any device for "tax avoidance" or were engaging in any "tax planning" other than an effort to comply with the 10 shareholder limitation.

CONCLUSION

For the reasons stated above, it is respectfully submitted that the decision of the United States Tax Court that there is no deficiency in the Taxpayer's Federal income tax for the calendar years 1964, 1965, 1966 and 1967 should in all respects be affirmed.

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February 3, 1975

CERTIFICATE OF SERVICE

It is hereby certified that service of this Brief has been made on opposing counsel by mailing four copies thereof on this 3rd day of February, 1975, in an envelope, with first class postage prepaid, properly addressed to them as follows:

Scott P. Crampton
Assistant Attorney General
Tax Division
Department of Justice
Washington, D.C. 20530
Attention: SPC:GEA:ALBailey

Glenn E. Coven, Jr.

APPENDIX

Internal Revenue Code

"SECTION 1371. DEFINITIONS.

(a) SMALL BUSINESS CORPORATION. - For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not-

(1) have more than 10 shareholders;

(2) have as a shareholder a person (other than an estate) who is not an individual;

(3) have a nonresident alien as a shareholder; and

(4) have more than one class of stock.

* * *

(c) STOCK OWNED BY HUSBAND AND WIFE. - For purposes of subsection (a)(1) stock which-

(1) is community property of a husband and wife (or the income from which is community income) under the applicable community property law of a State, or

(2) is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,

shall be treated as owned by one shareholder."

Income Tax Regulations, § 1.1371-1(d)

"(d) Number of shareholders - (1) In general A corporation does not qualify as a small business corporation if it has more than 10 shareholders. Ordinarily, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation are considered to be the shareholders of the corporation. For example, if stock is owned by tenants in common, joint tenants, or tenants by the entirety, each tenant in common, joint tenant, or tenant by the entirety is generally considered a shareholder, but see subparagraph (2) of this paragraph relating to stock owned by husband and wife. Persons for whom a stock in a corporation is held by a nominee, agent, guardian, or custodian will generally be considered shareholders of the corporation. If stock is owned by a trust which is subject to the provisions of subchapter D, F, H, or J of chapter 1 of the Code, or by a voting trust, the trust is considered the shareholder even though the dividends paid to the trust are includible directly in the income of the grantor or some other person. If stock is owned by a partnership, such partnership and not its partners is considered to be the shareholder.

(2) Stock owned by husband and wife. (i) Except as otherwise provided in this paragraph, in determining whether a corporation meets the 10-or-fewer-shareholders requirement of section 1371(a), stock which-

(a) Is community property of a husband and wife (or the income from which is community income) under the applicable community-property law of a State, or

(b) Is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,

shall be treated as owned by one shareholder. For this purpose, if a husband or wife owns stock in a corporation individually, and the husband and wife own other stock in the corporation jointly, the husband and wife will be considered one shareholder. However, if the husband and wife each owns stock in the corporation individually, they will

be treated as two shareholders. This subdivision applies only in determining the number of shareholders for purposes of section 1371(a)(1) and does not apply for purposes of any other provisions of subchapter S, chapter 1 of the Code. Thus, for example, the husband and wife will each be considered a shareholder for purposes of section 1372(a), relating to the requirement that all shareholders consent to the corporation's election, and section 1373 (a), relating to the inclusion in the shareholder's gross income of the corporation's undistributed taxable income."